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Tax treatment of donor-financed projects*

Summary

Projects involving development, humanitarian and other assistance provided by governments or public international organizations often enjoy tax exemptions. Exemptions may apply to imports and procurement of goods and services, and may extend to both direct and indirect taxes (including customs duties). Discussions among donors and recipients have identified problems with current practice. These, together with reduced tax rates and improvements in governance in many potential recipient countries, have led to a review of policy in some instances. This paper, whose primary purpose is to stimulate discussion of these important issues, summarizes the issues and proposes steps that could be considered both by donors and by countries that are recipients of assistance. It notes that there is an emerging movement towards an expansion of the situations where project assistance activities are subject to tax under the normal tax rules of the recipient country, and suggests that a group of donors and recipients of assistance, together with the member organizations of the International Tax Dialogue, could further explore these issues and possibly develop guidelines towards a more coordinated approach that countries would be free to adopt. Given the significance of these issues for the aid budget of donors, it is particularly important to closely associate donors in any work in this area.

* The present paper was prepared by the International Tax Dialogue (Coordinator: Victor Thuronyi). The views and opinions expressed are those of the authors and do not necessarily represent those of the United Nations.

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I. Introduction

1. The present paper contains a discussion of the tax treatment of international assistance projects. It was prepared by staff of the members of the International Tax Dialogue Steering Group[1] and has benefited from discussions at the first session of the Committee of Experts on International Cooperation in Tax Matters, held in December 2005, as well as input from stakeholders facilitated over the course of the current year by the International Tax Dialogue (ITD). Views expressed, however, are entirely those of the authoring staff and should not be taken to represent the views of any of the member organizations of ITD, or of their member countries.

2. International project assistance may be provided by governments, government-controlled agencies, international organizations, non-governmental organizations (NGOs), companies or individuals. Assistance may be designed to facilitate development or reform, may respond to natural disasters or other humanitarian crises, may take the form of peacekeeping operations, or may advance other purposes. It may take the form of grants, may be provided in kind, or may be financed by concessional loans. Tax[2] exemptions for various transactions under international assistance projects apply in many countries, often at the insistence of donors.

3. This paper considers the tax treatment of assistance provided by or on behalf of governments and international organizations, focusing on the impact and wisdom of tax exemptions. Many of the arguments developed here are also applicable to private charitable assistance, and the avoidance of distortions, abuse and increased administration costs points to like treatment of public and private assistance (so as to ensure, for instance, coherent treatment of interactions between the two, as when donors use NGOs as implementing agents). But private assistance also raises a distinctive set of issues, and so is not addressed here.[3] Likewise, the paper does not consider in any detail the issues raised by tax exemptions provided for diplomats, embassies, government officials, governments and international organizations generally.[4]

4. The next section of the paper summarizes current practice in the taxation of foreign project assistance. Section III then asks why donors might seek tax exemption in the recipient countries for the projects that they finance. Section IV argues that now is a good time to reconsider the presumption that such projects

[1] The International Tax Dialogue is an initiative of the Inter-American Development Bank (IDB), the International Monetary Fund (IMF), the Organization for Economic Cooperation and Development (OECD), the World Bank and the United Nations to encourage and facilitate discussion of tax matters among national tax officials and international organizations. See www.itdweb.org.

[2] Throughout the paper, "tax" and related terms relate to both domestic taxation and customs duties.

[3] For example, the definition of qualifying charity, distinction between charitable and commercial activity, and extent of tax exemptions offered under domestic law.

[4] The dividing line between these two is not always clear-cut. Embassies may run charitable projects, for instance, and, more generally, sometimes aid is provided in ways that would qualify for exemptions for governmental staff, diplomats and the like. Given, however, that these exemptions are accorded by a network of treaties, such as the Vienna Conventions, and customary international law which are motivated by policy reasons that differ from those applicable to the aid process, they are not considered in this paper.

should be tax exempt, and section V develops some options for change. Section VI contains the conclusions.

II. Current practice

5. The sums at stake in the tax treatment of aid are substantial. In the Niger, for example, tax expenditures on vouchers — one method by which exemptions may be implemented (see para. 21 below) — amounted in 2002 to about 18 per cent of project financing, and 10 per cent of all tax revenue. In the United Republic of Tanzania, customs exemptions for donors accounted for around 17 per cent of the gross value of imports in 2005. With any scaling up of aid, the quantitative significance of the issue will increase still further.

6. Tax exemptions relating to international aid take various forms. Imports of goods may be exempt from customs duties, VAT (or other general sales tax), excises and other indirect taxes. Goods or services procured locally may be exempt from VAT or sales tax. Income tax exemption may be extended to persons working under contracts (for example, employees and enterprises). There may be exemptions from other taxes as well.

7. Recently, some donors have changed their policy. Previously, the policy of the World Bank had been that it would not use its loans to finance taxes.[5] Recipient countries therefore had a choice. They could provide exemption for goods and services procured under Bank-financed projects or they could provide budgetary funds to pay for the portion of the project costs representing tax. On 13 April 2004, the World Bank changed its policy to allow financing of reasonable, non-discriminatory tax costs.[6] Going forward, therefore, recipient countries will not have to face the choice of providing exemptions for Bank-financed projects where their taxation system has been determined to be a reasonable one for purposes of this policy. The determination by the World Bank as to which taxes are treated as costs that can be financed by loans is made on a country-by-country basis as part of the Bank's overall country assistance strategy. Thus far, experience with applying the policy shows that in only very limited cases are taxes found to be unreasonable and therefore ineligible for Bank financing. The net result is that virtually all taxes have been considered as eligible for financing (of course, if a country were to introduce an unreasonably high tax, the Bank could consider it ineligible). The Inter-American Development Bank (IDB) and the Asian Development Bank (ADB) have recently adopted similar policies.[7] Similarly, the French Development Agency (Agence Française de Développement) has in recent years included in certain aid agreements ("Contrat de désendettement et de développement") the financing of taxes.

8. The reality of the means by which exemptions are provided for is complex, consisting of a variety of legal instruments and administrative practices being

[5] General Conditions Applicable to Loan and Guarantee Agreements, sect. 5.08: "no proceeds of the Loan shall be withdrawn on account of payments for any taxes levied by, or in the territory of, the Borrower ... on goods or services, or on the importation, manufacture, procurement or supply thereof" (as in effect before 13 April 2004).

[6] See BP [Bank Procedure] 6.00 (April 2004); OP 6 ("The Bank may finance the reasonable costs of taxes and duties associated with project expenditures").

[7] See, in the case of ADB, http://www.adb.org/Documents/Policies/Cost-Sharing-Eligibility-Expenditures/default.asp.

applied to a substantial number of different transactions in the context of each country's general tax rules. Exemption might be granted by the general domestic tax rules, by general rules of double tax treaties, by specific exemptions in domestic law directed to international assistance, or by bilateral agreement.

9. Possible transactions and taxes to which exemptions apply include:

- Goods are imported by a non-resident on a temporary basis (regime for temporary imports may apply) (possible exemption from customs duties, VAT and other indirect taxes)
- Goods are imported by a non-resident, but will not be re-exported (possible exemption from customs duties and VAT)
- Goods are imported by a resident, to be paid for using project funds (possible exemption from customs duties and VAT)
- Goods or services are purchased from a local supplier, using project funds (possible exemption from VAT)
- A non-resident individual comes to the country to provide services to be paid for using project funds and stays in the country for only a limited period of time (possible exemption from individual income tax and social contributions, perhaps under a general provision of domestic law, under treaty provisions or under a bilateral agreement)
- A government employee of a donor country comes to the recipient country to provide services related to the negotiation and implementation of a project and stays in that country for a certain period of time (possible exemption from individual income tax, perhaps under the provisions of a tax treaty)
- A non-resident contractor without a permanent establishment in the country provides services under a contract financed with project funds (possible exemption from profit tax, perhaps under a general provision of domestic law, under treaty provisions or under a bilateral agreement)
- A resident company (or a non-resident having a permanent establishment in the country) is hired to provide services to be financed using project funds (possible exemption from profit tax)
- Resident individuals are hired to work for a resident or non-resident contractor with project funds (possible exemption from individual income tax and social contributions)

10. The list in the preceding paragraph is not complete. It is intended to illustrate that the question of potential tax exemption arises in different contexts and requires drawing a line at some point. Few if any countries, for example, would exempt from tax the income earned by local permanent residents who are working for a company that is providing services under a contract that is financed by aid funds. In some cases, the general tax rules would provide for an exemption, without the need for a specific exemption for aid-financed projects. For example, a non-resident importing goods which will be taken out of the country after being used for a project might qualify under the terms of a general customs regime for temporary imports. A non-resident who provides services without having a permanent establishment in the country might not be subject to income tax under the general rules (many countries refrain from imposing income tax in such a situation, even where there is no double

tax treaty in effect). Or the terms of a generally applicable treaty for the avoidance of double taxation might provide for an exemption for a non-resident providing services without constituting a permanent establishment, again without specific reference to the project being aid-financed.

III. Why might donors not want to finance taxes?

11. A useful place to begin the analysis of this issue is with the textbook result in the theory of public finance that, if the sole concern is the welfare of a single recipient of support, then it is better to make gifts in cash rather than in kind; then the recipients, knowing best their own tastes and needs, can put the money to whichever use they find best, rather than consume whatever goods or services the giver has chosen to provide. Applied to the provision of international aid, this reasoning suggests that donors should be content to pay taxes on the support they provide, since that is akin to a simple cash transfer. But evidently this has often not been the case. so that the textbook result misses what at least some donors must regard as key aspects of aid provision. It is important to understand what these are. Why is it that donors have traditionally been, and in some cases continue to be, reluctant to agree to the recipient country's imposition of taxes in connection with their international assistance?

12. One reason — and there are no doubt others[8] — may be that the satisfaction donors feel from their generosity depends not on its monetary amount, or the well-being derived by the recipient, but on the specific goods and services that it delivers. (This corresponds to the "warm glow of giving" view of charitable contributions.) Suppose, for example, that donors care only about the number of schools that they finance. If it costs, say, $100,000 to build a school, assuming tax exemption of imported materials, but $125,000 if import duty must be paid, then from a budget of $1 million, 10 schools can be constructed if tax exemption is granted, but only 8 if tax must be paid. It might be easier, for example, to mobilize political support for such targeted assistance (building schools, vaccinating children, etc.) than for the provision of untargeted budget support: donors may simply feel they do not get the same recognition for budget support as for project aid.[9] In this way, donors may have a distinct preference for not paying tax even at an unchanged total cost to themselves. (There is, however, a downside: if targeted assistance turns out to be wasteful or unsuccessful, its visibility may make it more vulnerable to political criticism.)

13. Even this, however, is not a fully satisfying explanation. Suppose that the donor cares not about the total number of schools that it finances itself, but on the total number of schools in the recipient country. Then to some degree the donor should not care whether or not tax is paid, since the fungibility of funds means that the recipient can simply offset the implications of this by adjusting the use it makes of its own resources. Continuing the example of the previous paragraph, for instance, suppose that the recipient wants to have 11 schools. If assistance is

[8] It may also be, for example, that project assistance is preferred to budget support in part because of the greater ease of implicit or explicit tying, and/or in the potential taxation by the donor country of associated incomes earned by its residents.

[9] Taxes paid in relation to project assistance should of course be included in measured official development assistance, and so contribute to meeting donors' targets in this area.

exempt, it will thus devote $100,000 of its own resources to building another school to add to those provided by the donor. If tax is imposed, however, an additional two schools will need to be built to offset the reduced foreign provision. But the additional tax revenue of $200,000 that the recipient receives ($25,000 on each of the eight schools financed by the donor) will provide it with exactly enough additional resources to do precisely that (though it may choose not to spend all the receipts in this way). The real outcome is thus the same whether or not tax is imposed. While the empirical evidence on the extent to which aid is indeed fungible is mixed,[10] the implication is that when donors care not about their own warm glow of giving but about the real goods and services that the recipient enjoys, insisting on tax exemption may ultimately serve little real purpose.

14. In some cases, of course, donors may actively oppose providing any aid to the government that can be used directly for general budgetary purposes. For example, the donor may be responding to a humanitarian crisis and providing support directly to refugees, but may wish to provide no support to the government. Such an unwillingness to provide general budgetary support to the recipient may arise from any number of foreign policy reasons or might relate, for example, to a judgement by the donor that the recipient's public expenditure management framework is so flawed (e.g., involving substantial corruption) that direct budgetary support runs the risk of being largely wasted or diverted. This type of concern is very important for many donors, who consider that given their limited development budget, it is important that this budget be fully available for the implementation of the projects that they select, especially when these projects involve substantial transfer of know-how that can be used by the recipient country to promote further development.

15. Donors may also be concerned that if the money available for the direct implementation of the projects that they finance is reduced by tax costs, there will be less tangible results directly associated to their development budget, which may have an impact on the amount of public support for their development activities. This negative effect on public support could be more important if the taxes borne by their development budget are considered to be wasted or diverted in the recipient country, particularly at a time when efforts are made to increase the effective use of foreign aid to attain development goals such as the Millennium Development Goals. Such a negative effect on public opinion could translate into a reduction of the donors' development budget. Recognizing the delicate balance of considerations at work, some donors see the different forms of assistance as complementary.

16. A final reason for a reluctance to finance taxes is a concern that the recipient's tax policy, and/or its implementation, is unreasonable in some way. The concern may relate to: (a) the rates of taxation; (b) what is felt to be an unduly aggressive assertion of tax jurisdiction; or (c) taxation that actually discriminates against aid-financed projects or against a particular country. This concern may be magnified in situations where there is no treaty for the avoidance of double taxation between the donor country and the recipient country. Imposition of customs duties may be considered unreasonable, since customs are designed to provide protection for domestic industry, and this policy reason may be absent in the case of aid. Imposition of indirect taxes such as VAT may be considered unreasonable, since the

[10] See Shantayanan Devarajan and Vinaya Swaroop (1998), "The Implications of Foreign Aid Fungibility for Development Assistance", World Bank Policy Research Working Paper No. 2022.

incidence of the tax may fall either on the aid recipients or on the donor, neither of which may be considered an appropriate subject of taxation.

IV. Reasons for change

17. As a general matter, the reasons that some donors are reviewing their policy concerning tax exemption are twofold:

(a) First, there is a recognition that tax exemption leads to a number of problems: it increases the transaction costs relating to international assistance, facilitates tax fraud, and leads to economic distortions. The implementation of bilateral agreements providing for tax exemptions also tends to complicate tax administration and involve uncertainty as to which enterprises, goods or services are covered or how the exemption should be granted (direct exemption or refund mechanisms).

(b) Second, developments in a number of recipient countries have weakened some of the reasons for insisting on tax exemption. In the absence of compelling reasons to insist on tax exemption, there is a recognition that the general rules of taxation should apply to aid-financed projects.[11]

18. There is, it should be noted, an important difference between these two sets of reasons. To address the first, practical set of concerns, it would be enough that the exemption be eliminated: it does not matter, for this purpose, whether it is the donor or the recipient country that is responsible for paying the tax. The second set of concerns, in contrast, relate to precisely the question of whether it would not be appropriate for the donor to pay the tax[12] (bearing in mind, of course, that, at least as a first approximation,[13] the overall budgetary envelope of donors is likely to remain unchanged: paying tax will displace an equal amount of direct project finance). The following subsections elaborate on these two considerations.

A. The difficulties created by exemption

19. Depending on how they are structured, tax exemptions can result in substantial transaction costs. Because they involve departure from the generally applicable rules, contractors will have to seek specific exemptions. Because policies on seeking tax exemptions may differ from donor to donor, officials in recipient countries need to familiarize themselves with the various requirements, which can be confusing and complex, particularly if tax administration is weak. Since these policies are

[11] See generally Gerard Chambas, "Foreign-Financed Projects in Developing Countries and VAT Exemptions" (March 2005 presentation, available on www.itdweb.org); Operations Policy and Country Services, World Bank, "Eligibility of Expenditures in World Bank Lending: A New Policy Framework" (26 March 2004, available at http://www1.worldbank.org/operations/eligiblity).

[12] A core principle of public finance is that the real economic effect of a tax does not depend on which side of the transaction is formally liable to pay it. This does not apply in the present context, however, since one side of the transaction — the recipient — will receive the revenue raised.

[13] How the extent and nature of aid provided would respond to changes in its tax treatment depends on the political processes and, as discussed below, the preferences that generate support for the assistance in the donor countries — about which (especially the latter) relatively little is known.

superimposed on an existing legal framework, new legal issues may be presented (for example, whether a particular charge constitutes a "tax" which is eligible for exemption, or is instead a fee or user charge which is not eligible for exemption). In the case of VAT, exemptions tend not to work well, since they require the complex allocation of input credits (this would not be required if the exemption took the form of zero rating, but then the problem would be the creation of VAT refund claims on the part of suppliers, which places a strain on weak tax administrations). There will also be substantial costs in terms of administrative overhead (legal, monitoring and budgetary) on the part of the donor (the donor's budget rules may prohibit financing of taxes, which will require checking reimbursable expenses to see whether they include taxes; agreements need to be drafted and contracts reviewed). Where problems arise, human resources have to be devoted to dealing with them. In other words, the requirement to operate a special regime, as compared with the generally applicable tax regime, makes the contracts in question more expensive to administer.

20. Given the weakness of tax and customs administrations in most countries that are aid recipients, fraud is always a concern where tax exemptions are made available. Where tax or customs exemptions are granted, there is a substantial possibility of abuse of such exemptions. The abuse is likely to be more serious for indirect taxes. In the case of direct taxes, the issue is whether a particular contractor pays tax on its income from a project. The amount of tax at stake is relatively contained. However, in the case of indirect taxes, goods that have entered the country on an exempt basis can find their way into domestic commerce. If there is fraud in customs, all kinds of goods might be allowed to enter without paying VAT or customs duty, even though these goods should not actually qualify for exemption. The volume of goods involved might be several times the amount of the actual assistance. Depending on how the exemption is administered, fraud may well also arise from exempting local purchases from VAT. If the contractor is allowed to make purchases VAT-free upon presentation of an exemption card, the exemption is likely to be abused. (Income tax exemptions are not likely to involve as large a fraud problem, since the amount of the exemption will be limited to the income tax liability of the persons concerned.) Given the significant size of foreign aid, this potential for tax fraud can have a significant adverse effect on the domestic tax system.

21. Tax exemption imposes costs on tax administrations of recipient countries in keeping track of the various exemptions provided and administering them. This difficulty is amplified by the diversity of the practices and expectations of the multiple donors that recipient countries may need to deal with. The administrative burden and the risk of fraud can vary depending on the way that exemptions are structured. For example:

(a) In the case of VAT imposed on domestic supplies, the supplies can be exempted or, alternatively, a refund could be provided upon application by the purchaser. The latter mechanism would involve a better control on use of the exemption;

(b) Instead of providing an exemption, the recipient government might provide vouchers to contractors working under aid-financed projects, in the amount

of estimated indirect taxes.[14] The contractors could then use these vouchers to pay the taxes. The advantage of the voucher approach is that it allows transparent and up-front identification of the budgetary cost to the recipient government. On the other hand, administration of the voucher system (or exemption systems) involves administrative costs, and there is a risk that vouchers will be forged. Experience also indicates the importance of strong central control when multiple agencies are authorized to issue vouchers: there are cases in which unexpectedly high voucher issue has led to significant liquidity proble.ns;

(c) The government may take direct responsibility for the payment of taxes on foreign-financed projects. In practice, however, cash constraints may prevent timely fulfilment of these obligations, delaying projects and adding to the tasks of an already struggling tax administration.

22. Reducing the transaction costs that such schemes create for recipient countries is one of the factors motivating some donors to review their policies. It should be noted, however, that for some donors, the difficulties encountered by recipient countries in dealing with exemptions for aid should rather be addressed by increasing technical cooperation in the area of tax administration. These donors may also consider that addressing these difficulties may even increase the recipient country's capacity to manage projects more effectively.

23. Exemptions can also cause distortions. If, for example, imported goods to be used for a project are exempt, but no exemption is available for domestic purchases, then there will be a distortion in favour of imports. Private sector providers not enjoying tax exemptions on their inputs may find themselves at a disadvantage competing with projects that do. And exemptions may distort the input compositions of projects, with a bias towards the use of (exempted) capital and other material inputs and against the use of (taxable) labour.

24. Exemption can be legally problematic. In some countries, there is no proper legal basis for exemptions, i.e., they might be based on agreements that do not have the force of law. Even where a duly ratified treaty or law establishes exemptions, there are often difficulties of interpretation[15] arising from vague drafting, particularly where the exemptions are provided in laws separate from, and not properly integrated with, the tax laws. These difficulties are compounded where the Ministry of Finance and the tax authorities are not consulted prior to the granting of the tax exemption and have not been involved in the drafting of the relevant legal provisions.

25. Not least, granting exemptions to any market participants always runs the risk of creating pressures for further exemptions, whether directly as a means of alleviating competitive distortions that the initial exemption created or indirectly by creating a precedent that others can call on. Indeed many donors are vociferous in urging developing countries to cut back on exemptions in their wider tax systems. Some may find that this does not sit comfortably with continuing to press for exemptions for themselves.

[14] A voucher system is used in several countries, for example Benin, Burkina Faso, Cameroon, Côte d'Ivoire, Mali, the Niger, Senegal and Togo.

[15] This became a significant difficulty, for example, in Timor-Leste, and can arise too in drawing the line between diplomatic and other purposes.

26. It should also be recognized, however, that removing exemptions would itself create some potential difficulties. To the extent, for instance, that donors care about the quantity of real goods and services they finance, then imposing tax on them may in itself distort the allocation of their resources across countries charging different tax rates — and one could even conceive of a mutually damaging competition emerging as developing countries reduced the tax rates they imposed in order to attract donors. Such distortions seem unlikely to be significant, however, at levels of taxation that are "reasonable" in the sense discussed below. It may also be that, with aid flows typically more volatile than domestic tax revenues, removing exemptions would increase difficulties of budgetary management. The beneficial effects of higher average receipts, however, seem likely to more than offset this difficulty, the deeper solution of which, in any event, lies in reducing aid volatility. Finally, it should be kept in mind that the removal of exemptions will in some cases require renegotiation of existing bilateral agreements. The renegotiation cost needs to be taken into account in deciding whether removal of exemptions makes sense in specific cases.

27. On balance, there is little doubt that the distortions and practical difficulties that exemptions pose for recipient countries undermine, to some degree, the development objectives that the aid itself is intended to serve. And any scaling up of aid will amplify these difficulties.

B. The changing aid environment

28. The concerns about "unreasonable" taxation in recipient countries (see para. 16 above) have to some extent been overtaken by developments in many developing and transition countries. As a general matter, the level of tax rates has come down. Income tax rates in virtually all developing countries are much lower than they were, say, 30 years ago. Likewise, tariffs have been decreased with trade liberalization, thereby reducing the number of cases where high rates would apply. As far as the assertion of tax jurisdiction is concerned, many developing countries have unilaterally retrenched their taxing jurisdiction to what would typically be permitted under double tax treaties. For example, non-residents providing services in the jurisdiction are typically taxed only where they have a permanent establishment. Of course, there are instances where taxing jurisdiction goes beyond what is normally allowed under treaties. Concurrently, however, developing countries have entered into an increased number of double tax treaties. To the extent that the concern remains, the remedy might lie not in total exemption from tax of activities financed by donor aid, but a more limited exemption as would be called for by typical double tax treaties (for example, exemption from income taxation for non-residents who do not have a permanent establishment in the country).

29. The serious concerns about public expenditure management (see para. 14 above) remain in many countries, though others have made substantial progress. This suggests that, to the extent that the main concern of a donor is weak public expenditure management, this concern can be addressed on a case-by-case basis by reviewing the situation in the particular countries where the donor is delivering aid. A review of the public expenditure management framework could convince donors, in relation to certain recipients, that this concern has been satisfied. Such a review could take advantage of the public expenditure management initiatives currently

under way in a number of countries, with the participation of IMF, the World Bank, and other agencies.

30. The concern about public expenditure management assumes that any direct budgetary support is vulnerable to corruption and mismanagement. It is important to bear in mind, however, that there can also be corruption, mismanagement and inefficiency in project implementation (though donors may feel less exposed to risk on this account since they have greater control over project implementation than over the general expenditure management system).

31. Ultimately, it is hard to find a convincing rationale for a donor who is simultaneously providing both targeted and general budgetary support to insist on tax exemption, since the same mix of support can be provided without any exemptions by reducing the level of general budgetary support.[16] More generally, fungibility means that even the provision of targeted support may be difficult to distinguish from general budgetary support. Because targeted support may allow the recipient to reduce its general public expenditures in the area which is receiving targeted support, the targeted support may, at least in part, have the same effect as general budgetary support.

32. Budget support has become an increasingly important part of overall aid flows over recent years, rising from 10 percent of total aid commitments in 2000 to 20 per cent in 2005.[17] This reflects debt relief and, more widely, increased awareness of the fungibility issue and an appreciation of the potential inefficiencies that project-based assistance can create given the better information that recipients may have on their own needs.[18] This increased willingness to provide budgetary support points to a potential incoherence in simultaneously insisting on tax exemption.

33. To the extent, nevertheless, that the donor is under a budget constraint and wishes to achieve specific policy aims with the assistance, this desire can be addressed in ways other than tax exemption. For example, suppose that the donor is interested in combating malaria in the recipient country. The donor could negotiate with the recipient government, insisting that this government also provide public funds directed to achieving the goals of malaria eradication (not necessarily as part of the same project). Such a flexible approach could satisfy donor concerns without needing to use tax exemption as a policy tool.

34. In some cases, and despite these various developments and considerations, the reasons for insisting on tax exemption remain valid. Thus, if the donor simply is unwilling to provide general budgetary support (see para. 14 above), that is the end of the matter until the conditions leading to this unwillingness change. And indeed in such circumstances — the donor of the example above, who cares only about the warm glow it derives from the number of schools financed — taxing aid may be

[16] For example, suppose that a donor finances projects in the amount of $10 million and also provides general budgetary support of $5 million. Suppose that removal of tax exemptions increases the cost of the projects to $12 million. In this case, if general budgetary support is reduced to $3 million, the effect will be the same with and without tax exemptions.

[17] See Sanjeev Gupta, Catherine Pattillo and Smita Wagh (2006), "Are Donor Countries Giving More or Less Aid?", IMF Working Paper WP/06/01, forthcoming in the *Review of Development Economics*.

[18] The same general consideration has motivated a trend towards untied aid.

counterproductive, in the sense of worsening the outcome for both recipient and donor.[19]

35. There is obviously unlikely to be a single correct answer — applicable to all donors, all recipients and all projects — as to whether donors should insist on exemption or not. It may well be, for instance, that donors attach some positive value to both the real goods and services that they provide and the revenue receipts of the recipient government. (And indeed their notions as to what constitutes a "reasonable" level of taxation may reflect the relative weights that they attach to the two.) It will thus be critical that donors be comfortable with the use made of their support. At the same time, there are clearly considerable benefits to all parties in the adoption of a broadly common approach. As in other areas of aid practices, in relation to taxation too a concerted effort to secure some degree of coordination will be needed if real simplification is to be achieved.

V. Options

36. As noted earlier, the two broad sets of considerations set out in the previous section are in a conceptual sense distinct. The operational difficulties posed by exemption in principle can be resolved by measures — such as a voucher system — that levy tax but pass the cost of this to the recipient government (which would thus have a net revenue gain, apart from any owing to reduced abuse, of zero). Whether tax should be payable by the donor, on the other hand, depends on a range of political and economic considerations. Current trends, however — an increased awareness of the difficulties created by exemption and an easing of some of the concerns that have traditionally made donors reluctant to pay tax on their support — mean that both considerations point increasingly towards systematic payment of tax in connection with projects financed by donors.

37. In some cases, of course — as stressed earlier — donors will wish to continue to insist on exemption. In other cases, they may be willing to drop such demands, depending on the situation in the recipient country, not least in relation to the effectiveness and transparency of public expenditure management. It is unlikely that all donors will agree to unlimited taxation of all aid, but it is quite possible, and a reasonable objective, that many aid-financed projects will become subject to the normal tax regime over time.

38. Some donors will find attractive the approach of the World Bank, under which aid projects include the financing of tax costs, unless the taxes are material in amount and (a) excessive or (b) discriminatory.[20] In the case of donors that operate in many countries, this approach would require looking at the details of the tax regime in each country. It would, however, be a duplication of effort for each donor to carry out such a review on its own, raising the question as to whether

[19] Suppose, to take a simple example, that the payoff to the donor from giving depends only on the number of real goods (schools, say) acquired, while the recipient is indifferent between schools and the money equivalent. Then taxing the provision of schools will leave both worse off if the donor's price elasticity of demand for schools exceeds unity: for then both the number of schools and the monetary value of aid provided will fall.

[20] Provision would need to be made to deal with possible changes in the tax regime during the life of the project, which might alter the donor's assessment. Guidelines on this may be needed to assure reasonable certainty to both donor and recipient.

internationally agreed standards could be applied. Unfortunately, it would be quite difficult to agree internationally on whether the tax regime in a particular country is "reasonable", and cumbersome to establish procedures for such a determination. Necessarily, judgement is involved and one possibility is simply to leave this determination to the judgement of each donor concerned. But, in the spirit of wider efforts in better coordinating aid practices, duplication of effort could be minimized if both donors and recipients share information. For example, the analysis carried out by World Bank staff is reflected in "country financing parameters" which are supported by "country notes".[21] If these (together with similar exercises, if any, carried out by other donors) were shared among donors, together with any responses that the authorities wished to make in the case of taxes considered unreasonable, then all could benefit from the analysis carried out.

39. The intention of such assessments would not be to pass a judgement on the wider quality of a country's tax system — and this would need to be clear to all — but simply to make it easier for donors to conclude that taxes in a particular country are (or are not) broadly in line with normal international practice, and hence create some presumption that they should be allowed to apply to aid projects. In practice, therefore — and as is to some degree already the case in relation to public expenditure management systems — donors could rely on reviews carried out by others, to the extent that those reviews are supported by credible documentation and analysis.

40. An alternative would be for donors and recipients to enter into discussions setting out a framework under which some exemptions for international assistance might be lifted.

41. The two alternatives are not mutually exclusive. Different donors may want to move at different paces. The approach of coordinated donor discussion might also be tried in a few countries on a pilot basis.

42. Apart from the general question of the reasonableness of the tax regime in a particular country, there may be specific cases where the imposition of tax by the aid recipient might be considered unreasonable. An example would be the imposition of import duties on the import of supplies to be used for relief of disasters, health emergencies, famine and other humanitarian emergencies. Donors might be more willing to abandon requests for exemptions in general if these specific transactions were not subject to tax. This could be achieved in several ways: (a) countries might unilaterally enact such exemptions as part of their domestic tax laws, perhaps in response to internationally discussed guidelines; and (b) the exemptions could be provided by a multilateral treaty. The first approach might be easier to achieve, given the time and effort needed to negotiate a treaty. It would also allow the provisions to be tailored to the tax laws of each country.

43. Guidelines for specific transactions that should not be subject to tax could accordingly be developed. These might cover the following situations:

- No taxes or duties should be imposed on the import of goods to be used to respond to humanitarian crises such as natural disasters, famine or health emergencies. The existence of the crisis should be recognized by the

[21] See Operations Policy and Country Services, World Bank, "Eligibility of Expenditures in World Bank Financing: FY05 Report on Implementation Experience" (3 October 2005, available at http://www1.worldbank.org/operations/eligibility).

appropriate political authorities, and the imports should be carried out by foreign governments or non-profit organizations at the invitation of the recipient country. The goods should be either for use in the response (to be removed once operations are over) or for free distribution to victims of the crisis.

- Physical presence of an individual on the territory of an aid recipient for the purpose of responding to a crisis (as described above) would not be taken into account in determining that individual's status as a resident for purposes of individual income tax.

- The employment income of an employee of the government of a donor country or of a public international organization would generally be exempt from taxation in a recipient country so long as the presence of the employee in that country is related to the provision of aid under a project financed by the donor country or organization.

- Where a non-resident enterprise (a company or an individual consultant) carries out activities in a recipient country on behalf of a foreign government in the framework of an approved aid project, the income received by the non-resident relating to these activities would not be subject to tax in the recipient country where the non-resident does not have a fixed place of business (permanent establishment) on the territory of the recipient for a period exceeding a specific length of time (e.g., six or 12 months).

- The tax rules applicable to transactions connected with aid projects financed by foreign governments or public international organizations should in no cases be discriminatory or unusually burdensome compared with the otherwise applicable tax regime in the recipient country.

44. Several of these guidelines would duplicate the exemptions typically available under bilateral tax treaties, and would not be needed in cases where such a treaty existed between the donor and the recipient country. However, the existing treaty network is far from comprehensive and is unlikely to become so at any time in the near future. If countries that are aid recipients wished to follow such guidelines in their domestic law, the implementation would of course be quicker.

VI. Conclusions

45. **One of the findings of the present paper is that there is an emerging movement towards an expansion of the situations where project assistance activities are subject to tax under the normal tax rules of the recipient country. This paper suggests that a group of donors and recipients of assistance, together with the member organizations of ITD, could further explore these issues and possibly develop guidelines towards a more coordinated approach that countries would be free to adopt.**

46. **It is recognized that some donor countries would not be in a position to adopt the approach of allowing recipient countries to tax the donor's project assistance activities. Clearly, each donor country must remain free to establish the conditions under which it is willing to provide international assistance. But, and while there will no doubt be exceptions, there are good reasons for limiting the extent to which tax exemptions are provided. Where there is sufficient**

confidence in governance structures in recipient countries — not least in relation to public expenditure management — countries and international organizations providing aid may wish to consider not to insist on exemption from tax for transactions relating to aid projects, except in the areas where the rules in the recipient country for taxing aid-related transactions fail to comply with internationally accepted guidelines or are considered to result in excessive taxation.

47. **By the same token, recipient countries should be encouraged to strengthen their public expenditure management systems and review their tax/tariff structures so as to provide donors with the assurance they will need that any taxes paid on aid will be reasonable in amount and put to good use.**

48. **While donors will naturally differ in their concerns and priorities, they may wish to discuss further the issues described in this paper and consider the case for moving towards a better coordinated system on the basis of internationally agreed concepts, criteria and practices. Coordination does not imply that all donor countries will agree to elimination of exemptions. Some may continue to insist on certain exemptions in all cases or on a case-by-case basis. Even though a more coordinated system will accordingly not involve uniform practice, it promises to clarify, limit and standardize exemptions to a substantial degree.**

49. **Guidelines referred to in paragraphs 42 to 44 could be developed so as to facilitate the dialogue among aid donors and recipient countries. These guidelines could be developed with the participation of donor and recipient countries. One option would be for ITD to establish a working group that would allow these stakeholders to further explore the issues discussed in this paper and possibly develop guidelines towards a more coordinated approach that countries would be free to adopt. Given the significance of these issues for the aid budget of donors, it is particularly important to closely associate donors in any work in this area.**

50. **Countries and international organizations providing international assistance should be encouraged to share with each other and with recipient countries analyses of the reasonableness of tax rules for the taxation of aid-project-related transactions by recipient countries.**

51. **In cases where tax exemption for aid-related transactions is contemplated, countries are encouraged to use mechanisms that minimize administrative burdens and reduce fraud. Examples are direct payment by government (though ensuring payment can be problematic), use of refund schemes in the case of VAT (though establishing proper control of VAT refunds is a continuing challenge in many developing countries) and the use of vouchers (though such schemes also have their difficulties, as noted earlier). While some form of control is clearly advisable, all of the options have serious difficulties.**

52. **In cases where tax exemption for aid-related transactions is contemplated, the parties are encouraged to use legal instruments that support the rule of law in recipient countries by:**

- **Making sure that exemption is provided by law or, if provided under agreements, that the agreements are authorized by law;**

- **Identifying with specificity the transactions benefiting from exemption, the applicable taxes, and the conditions for benefiting from exemption.**

53. **To provide the transparency and information needed for policymaking and public discussion, aid recipients should be encouraged to prepare and publish tax expenditure analyses indicating the tax foregone as a consequence of exemptions granted on foreign assistance.**

54. **Additionally, donors negotiating agreements for exemption could take a flexible approach, agreeing to taxation of those kinds of transactions where fraud and administrative expenses are likely to be particularly high. There is no reason, in other words, why exemption needs to be extended on a blanket basis. It can be tailored to minimize problems of administration.**

55. **This paper has focused on the treatment of project aid provided by governmental agencies. Many of the same economic and practical concerns also arise in relation to the provision by NGOs and private foundations, and difficulties may be created by extending different tax treatment to support from such sources. It could be argued that there should also be a similar treatment in that case. But the distinctive issues raised by private giving — both definitionally and perhaps too in terms of the underlying motivation for giving — call for distinct analysis, which is left to the future.**